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**Many of** the world's economies are still grappling with repercussions from the widespread currency crises of 1997-1998. In emerging markets in particular, capital flows remain sporadic and have yet to return to pre-1997 levels.

This situation persists because there is still inadequate popular support in emerging market countries (EMCs) for much needed changes in economic policy and corporate governance. Such support will only be garnered if most citizens are convinced that they

will benefit from market-oriented reforms.

In practice, that means that they will have to have greater access to capital both for small businesses and home ownership. The payoff could be enormous, greatly improving the prospects for political and social stability worldwide. Fortunately, most emerging mar-

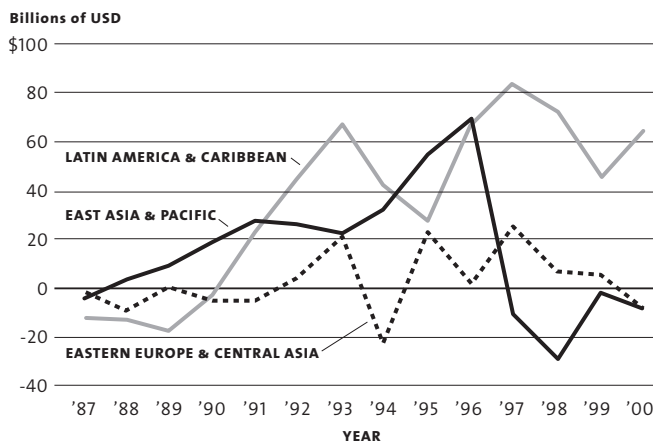
ket economies – if not their citizens – seem ready for the transition. Some 50 countries with a combined population of 1.5 billion have already achieved gross domestic products per person comparable to those at which the United States and other countries first adopted middle-class oriented policies. The main barriers to achieving these goals are the lack of stable currencies, credible central banks, adequately

capitalized regional and international financial institutions, and liquid, well-regulated capital markets.

### CAPITAL FLOWS

The currency crises since 1997, combined with Japan's financial and economic setbacks,

### NET CAPITAL INFLOW TO EMCs



SOURCE: International Financial Statistics

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## INSTITUTE VIEW

### 2002 CAPITAL ACCESS INDEX: SELECTED COUNTRIES

2002 CAI RANK	COUNTRY	CAI 2002 SCORE	CAI 2001 SCORE	CHANGE IN SCORE
1	Hong Kong	5.65	5.58	0.07
2	United Kingdom	5.59	5.63	-0.04
3	United States	5.50	5.72	-0.22
4	Singapore	5.43	5.36	0.07
5	Switzerland	5.38	5.46	-0.08
6	Netherlands	5.35	5.49	-0.14
7	Canada	5.22	5.25	-0.03
8	New Zealand	5.16	5.14	0.02
10	Australia	5.00	5.08	-0.08
10	Finland	5.00	5.04	-0.04
10	Taiwan	5.00	5.00	0.00
14	Germany	4.96	5.09	-0.13
16	Japan	4.88	4.85	0.03
18	South Korea	4.78	4.64	0.14
21	Israel	4.71	4.74	-0.03
24	France	4.66	4.81	-0.15
26	South Africa	4.62	4.47	0.15
28	Malaysia	4.56	4.63	-0.07
29	Chile	4.53	4.72	-0.19
30	Italy	4.45	4.54	-0.09
31	Thailand	4.37	4.56	-0.19
32	Jordan	4.24	4.04	0.20
33	Hungary	4.21	4.34	-0.13
34	Panama	4.19	N/A	N/A
35	China	4.18	4.17	0.01
38	Botswana	4.12	4.00	0.12
38	Poland	4.12	3.84	0.28
42	Czech Republic	4.06	4.27	-0.21
42	Egypt	4.06	4.34	-0.28
45	Argentina	4.02	4.31	-0.29
47	Philippines	3.96	4.04	-0.08
52	Nicaragua	3.88	4.18	-0.30
53	Slovak Republic	3.83	4.00	-0.17
59	Qatar	3.70	N/A	N/A
62	India	3.68	3.85	-0.17
64	Mexico	3.65	3.77	-0.12
69	Brazil	3.59	3.77	-0.18
70	Pakistan	3.56	3.70	-0.14
75	Indonesia	3.50	3.76	-0.26
77	Saudi Arabia	3.48	N/A	N/A
82	Costa Rica	3.39	3.46	-0.07
83	Ivory Coast	3.36	3.54	-0.18
84	Colombia	3.35	3.51	-0.16
85	Turkey	3.33	3.48	-0.15
87	Venezuela	3.17	3.33	-0.16
91	Zimbabwe	2.89	3.24	-0.35
92	Ukraine	2.83	2.61	0.22
93	Russia	2.74	2.85	-0.11
95	Iran	2.64	N/A	N/A

**NOTE:** The Milken Institute's ongoing Capital Access Index (CAI) ranks countries by entrepreneurs' ease of access to capital. The five components of the CAI are:

- General economic environment
- Efficiency and competitiveness of the banking system
- Equity and bond market development
- Access to international capital
- Sovereign credit ratings

dramatically curtailed worldwide appetites for investing in EMCs. Each of the three large regions of EMCs – Eastern Europe, East Asia

and Latin America — have seen a collapse in capital flows since 1997, and both East Asia and Eastern Europe have actually suffered net capital outflows.

### GLOBALIZATION AND GROWTH AT RISK: CAPITAL ACCESS POST-9/11

Against this backdrop, global capital access took another dramatic plunge after September 11. During the third quarter of 2001, the gross volume of capital raised by EMCs in the international capital markets fell by more than 50 percent. The immediate effect of Sept. 11 was a flight to quality in fixed income investments in the U.S. Investors, fearing a deep and lengthy recession, dumped high-yield debt for investment-grade bonds. When the market reopened after the attacks, the spread between the Merrill Lynch High Yield Master Index and the Merrill Lynch AAA-rated corporate index jumped from 7.5 percentage points to 9.2 percentage points. At the same time, the Fed's actions to increase liquidity steepened the yield curve, as short-term rates declined sharply but the long end remained unchanged.

Widening quality spreads and the steepening yield curve have brought the two-tiered capital market into sharp relief. Credit is cheap for investment-grade borrowers, but lower quality sovereign and corporate borrowers are out of luck. By no coincidence, integration of the world's economies appears to have stalled and, in some regions, is now reversing.

Net private flows to many emerging markets are likely to remain negative for some time. Should this trend continue through 2002, many emerging economies will have difficulty refinancing an estimated \$160 bil-

lion due in private debt. These problems will resonate throughout global financial markets and amplify systemic risk.

Falling portfolio flows and bank loans have been responsible for much of the decline. Note the changing pattern of capital flight for developing countries in the exhibit to the right. Capital from poorer regions has flowed into the developed countries – particularly the U.S., where it funds a widening trade deficit.

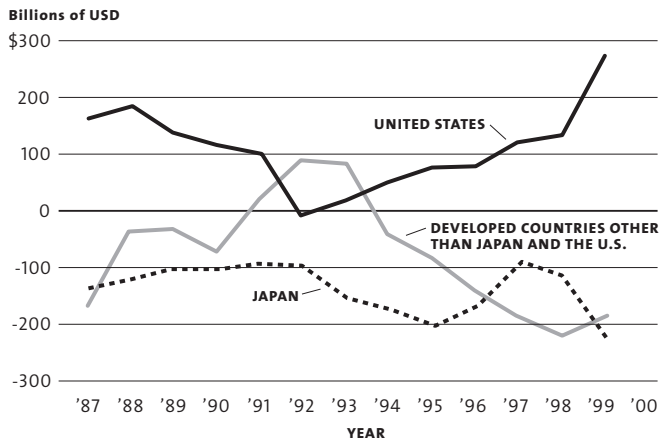
Meanwhile, foreign direct investment, typically a less volatile source of long-term funding, has changed little for EMCs in Europe, while inflows for EMCs in East Asia and the Pacific have declined only slightly. Latin America, on the other hand, has seen a greater inflow of FDI in recent years, although Argentina's default may dampen this trend.

As private sources of capital for the EMCs have dwindled, multilateral lenders like the International Monetary Fund, whose resources have been diverted by more acute financial crises, have not covered the resulting shortfall. Indeed, growth in the resources of these institutions has failed to keep pace with the volume of international capital flows. In 1990, IMF resources were equal to 220 percent of private capital flows to emerging markets; by 1999 this figure had fallen to 96 percent.

## GLOBAL TRADE

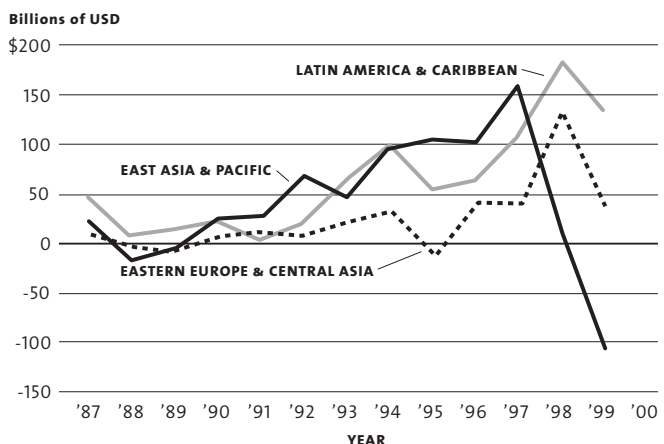
The threat to international financial integration posed by the decline in capital flows to

## NET RECEIPTS OF FLIGHT CAPITAL



SOURCE: World Development Indicators, World Bank

## NET CAPITAL FLIGHT FROM EMCs



SOURCE: World Development Indicators, World Bank

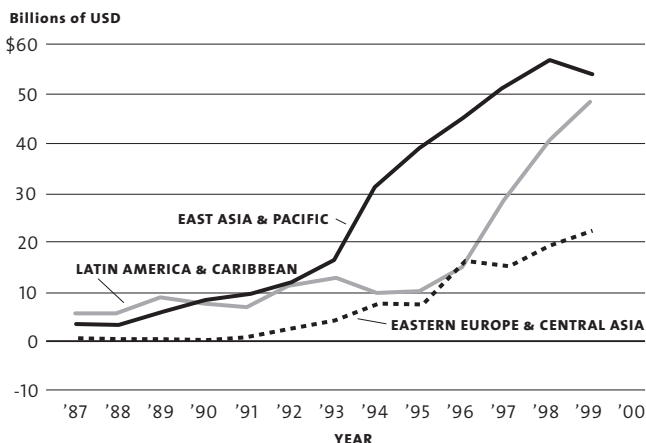
EMCs is reflected in the stalling of global trade in 2001. Trade in merchandise, which grew an average of 6 percent annually between 1990 and 2000, rose by just 1 percent in the first half of 2001.

## MISSING MARKETS

Growth in jobs, income and wealth are closely

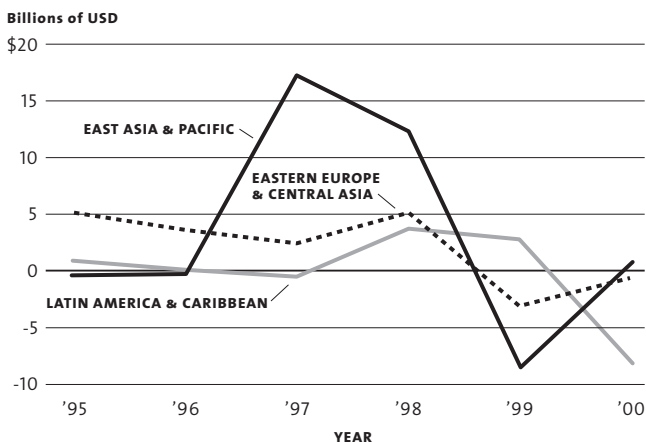
## INSTITUTE VIEW

### NET FOREIGN DIRECT INVESTMENT IN EMCs



SOURCE: World Development Indicators, World Bank

### NET IMF FINANCIAL FLOWS TO EMCs



SOURCE: World Development Indicators and International Financial Statistics

tied to the development of financial institutions and markets. Financial system development, as measured by the ratio of credit to gross domestic product, is, in turn, negatively correlated with economic volatility. Access to capital is the key for mobilizing savings, reducing risk over time and across industries, monitoring managerial behavior and achiev-

ing efficient asset pricing.

In addition to fostering economic stability, a deep and liquid financial system would engender social stability. It would nurture the development of a middle class, bridging existing income polarization. It would provide access to futures markets, which allow commodity producers to protect themselves against the idiosyncratic risks of farming. And it would even allow for more efficient conservation of fragile environmental assets by means of trading in emissions.

With a healthy bond market, an asset that would otherwise be classified as illiquid, such as property or a bank loan, could be securitized, allowing lenders to diversify their exposure to one borrower and thus extend more credit. Decades of dependence on banks as the main channel of capital allocation and sluggish development of equity, bond and venture capital markets have made such diversification impossible – and the recovery in the Asian economy, as a prime example, more difficult.

What is true of Asia also holds for most developing countries where financial systems development has been arrested by inactive

– and thus illiquid – financial markets. Domestic financial intermediaries and markets in developing countries are often small and weak. Of EMCs, only China and Brazil have financial assets that amount to more than 1 percent of the world total. An inactive market is tantamount to no market at all. Small markets not only have higher operating costs, but

also are riskier. Less liquidity leads to excessive volatility as prices fluctuate in the absence of market makers. Inefficient markets combined with insufficient and poor quality regulation, ineffective supervision and weak enforcement invite fraud and subsequent bank and market runs.

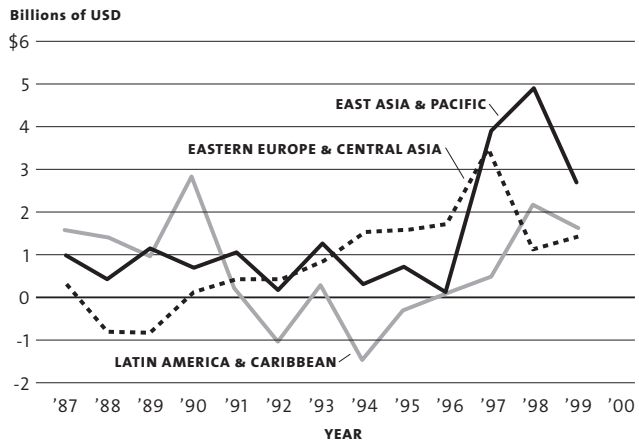
Dysfunctional banking systems tend to go hand in hand with dysfunctional stock and bond markets. Both occur in countries that poorly protect property rights, shareholder rights and creditors' rights.

### GLOBALIZATION'S BACKLASH: HISTORICAL PRECEDENTS

The current backlash against globalization is not unprecedented. At the beginning of the 20th century, many economies had highly developed stock markets. But, with the opposition to globalization that culminated in the unwinding of market integration and the retreat into autarky in the 1920s and 1930s, markets were downsized and their powers were limited through regulations supported by established economic interests. The effects of this retrenchment were not fully undone until the 1970s.

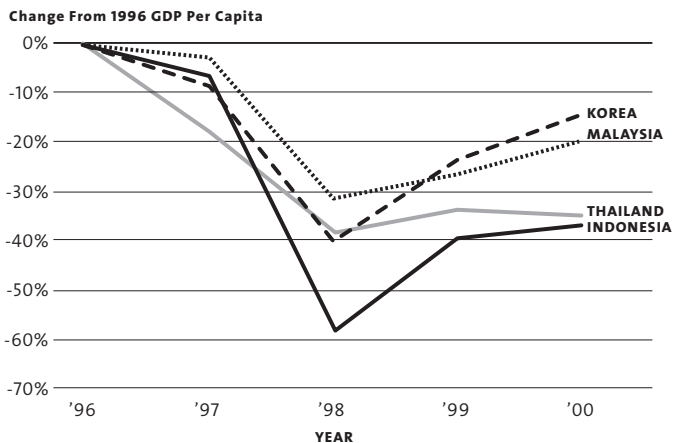
Not surprisingly, economic elites frequently lobby hard against globalization and capital flow liberalization. Open trade limits the ability of politicians to protect older firms. Capital access enables new entrepreneurs to attract foreign capital and local savers to invest in firms other than those controlled by existing elites. Today's anti-globalization forces focus on the same sore points as their 19th century counterparts – the costs of

### NET WORLD BANK FINANCIAL FLOWS TO EMCs



SOURCE: World Development Indicators, World Bank

### PER CAPITA GDP CHANGE IN THE ASIAN TIGERS

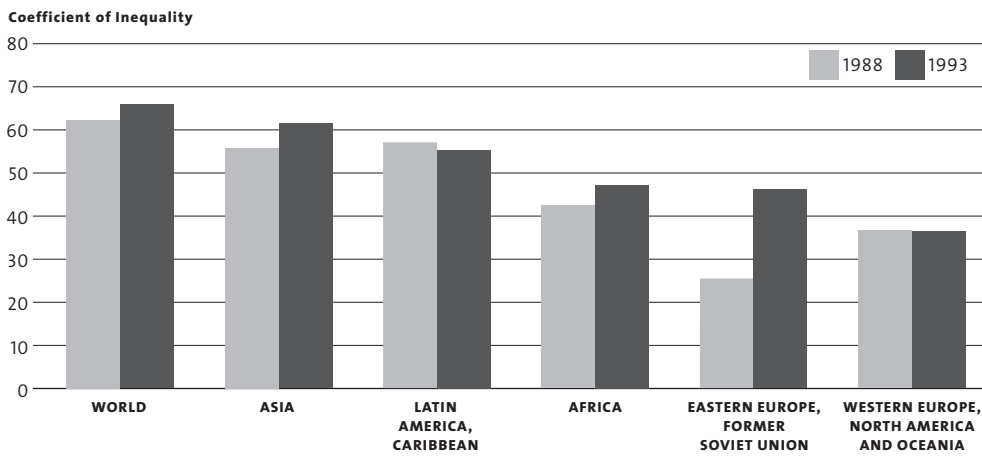


SOURCE: International Financial Statistics

integration to established economic interests in both developing and developed countries, and the failure of globalization to provide a more equitable distribution of income.

Globalization, which is guided by the same export-led growth policies that informed 19th century economic integration, also shares its principle flaw. Globalization has created a world economy, but has yet to produce a

## INEQUALITY IS HIGH AND INCREASING IN EMERGING MARKET COUNTRIES 1988-1993



SOURCE: UNDP, United Nations

world middle class. In fact there is evidence that inequality increased over the two great periods of globalization. But, the retreat into autarky failed to reverse the trend.

### THE MISSING MIDDLE CLASS

The absence of efficient capital markets in many emerging economies, the diminishing ability to drive growth through exports, and the defensive efforts of long-standing economic interests have led to growing income polarization both within and between countries in recent decades. They have thus undermined the rise of a middle class that could be a source of growth-enhancing cultural values and sustainable demand-driven expansion.

A recent World Bank study assayed this striking level of income polarization. It assumed, somewhat arbitrarily, that the global middle class consisted of people with incomes, adjusted to represent purchasing power, between \$3,470 and \$8,000. The researchers estimated its size at 11 percent of the world's population. Some 78 percent of the world was described as poor, with

incomes below the \$3,470 threshold.

Unlike most OECD countries, which have a large and dominant middle class and smaller groups of poor and rich, the EMCs are characterized by two extremes. There are some rich individuals, a great many poor and a tiny number of people who might be deemed middle class. And inequality has risen even over the last few decades. Only the wealthy countries of Western Europe, North America, Oceania and the mostly middle-income countries of Latin America have seen modest decreases in inequality.

The richest 10 percent of the world's population accounts for 50 percent of income, while the bottom half accounts for a mere 9 percent of world income. Comparisons between regions yield similarly striking disparities. For example, an individual with the median income in Africa would have an income in the bottom 5 percent in Western Europe, North America or Australia. Conversely, a person with the median Western European, North American or Australian income would be in the 95th percentile of incomes in Africa.

This lack of a sizable world middle class is

## COMPARISON OF REGIONAL AVERAGE INCOME

A median income in the regions listed across the columns...

A median income in the regions listed across the columns...			WESTERN EUROPE, NORTH AMERICA AND OCEANIA	LATIN AMERICA	EASTERN EUROPE AND THE FORMER SOVIET UNION	
	AFRICA	ASIA				
...would place an individual in the following income percentiles for the regions listed down the rows.	AFRICA	50th	49th	73rd	74th	95th
	ASIA	52nd	50th	74th	75th	94th
	EASTERN EUROPE AND THE FORMER SOVIET UNION	28th	27th	50th	52nd	86th
	LATIN AMERICA	26th	25th	48th	50th	83rd
	WESTERN EUROPE, NORTH AMERICA AND OCEANIA	5th	6th	14th	17th	50th

**SOURCE:** Branko Milanovic and Shlomo Yitzhaki (2001), *Decomposing the World Income Distribution: Does the World Have a Middle Class?* World Bank working paper. [http://econ.worldbank.org/files/1423\\_wps2562.pdf](http://econ.worldbank.org/files/1423_wps2562.pdf)

both an efficiency and an equity issue. Using data from the UNU/WIDER-UNDP World Income Inequality Database, we find that income inequality is statistically correlated with lower overall per capita income levels.

By the same token, inequality is significantly correlated with weak property rights. A high Gini is associated with a higher score on the 2002 Heritage Foundation Index of Economic Freedom. The Gini coefficient is used to measure the breadth of diversion between incomes in a society; the higher the coefficient, the wider the disparity. The Heritage Index is a ranking of world economies' conduciveness to free enterprise. Those most conducive receive the lowest scores.

Critics of globalization are right when they claim that the world has a hugely unequal distribution of wealth and that this inequality is important. However, they are wrong in asserting that a retreat from globalization is the remedy. While it is true that inequality decreased in the OECD countries during the post-World War I period of autarky, inequality between countries increased.

Adherence to development policies that do not enhance growth challenges globalization in this century, too. What is needed is neither export-led growth nor autarky (the Hobson's choice of the pro- and anti-globalization debate) but rather globalization based on the democratization of capital access.

## POLICY IMPLICATIONS OF THE GLOBAL CAPITAL ACCESS INDEX

Financial integration and financial sector development do not have to be sacrificed to flatten the global distribution of income. Development of a middle-class and development of an efficient financial sector reinforce each other; policies that facilitate wider home and business ownership also stimulate and strengthen the financial system. The problem of restructuring developing countries' debt can also be addressed through the creation of deep and liquid capital markets.

Capital market depth, in turn, is supported by the securitization of home and small business loans, credit-enhanced corporate debt issuance and the expansion of lending and equity investment to small- and medium-sized businesses.

Just as inequality is negatively correlated with prosperity, inequality is negatively correlated with the ability of entrepreneurs to gain access to the capital they require to open businesses or expand existing ones. Countries with high levels of inequality tend to be characterized by substantial barriers to capital access and thus, other things being equal, they tend to underperform economically. **M**